IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of IRVING WHITEHOUSE COMPANY, a Corporation, Bankrupt

L. C. REAM, HAZEL MOWERS, MABEL CONNOR, H. E. WOODLAND, MAUDE MOWERS, OSCAR LANTOR, CHARLES THEIS, ALEXANDER STEPHENS, O. W. WITTMER, T. S. LANE, DAVID ACKERMAN, STANLEY HODGMAN, AUGUSTA W. HOWELL, *Petitioners,*

vs.

W. S. McCREA, as Trustee in Bankruptcy of Irving Whitehouse Company, a Corporation, Bankrupt, *Respondent.*

No. 4075

Appeal and Petition to Revise from the District Court, Eastern District of Washington

Appellants' and Petitioners' Reply Brief

GRAVES, KIZER & GRAVES,
WAKEFIELD & WITHERSPOON,
ALLEN, WINSTON & ALLEN,
FABIAN B. DODDS,
JOSEPH McCARTHY,
SAMUEL EDELSTEIN,
E. B. QUACKENBUSH,
Spokane, Washington,
Solicitors for Appellants and Petitioners.

EMPIRE-PACIFIC PRINTING CO., SPOKANE

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

In the Matter of IRVING WHITEHOUSE COMPANY, a Corporation, Bankrupt

L. C. REAM, HAZEL MOWERS, MABEL CONNOR, H. E. WOODLAND, MAUDE MOWERS, OSCAR LANTOR, CHARLES THEIS, ALEXANDER STEPHENS, O. W. WITTMER, T. S. LANE, DAVID ACKERMAN, STANLEY HODGMAN, AUGUSTA W. HOWELL, *Petitioners,*

vs.

W. S. McCREA, as Trustee in Bankruptcy of Irving Whitehouse Company, a Corporation, Bankrupt, *Respondent.*

No. 4075

Appeal and Petition to Revise from the District Court, Eastern District of Washington

Appellants' and Petitioners' Reply Brief

GRAVES, KIZER & GRAVES,
WAKEFIELD & WITHERSPOON,
ALLEN, WINSTON & ALLEN,
FABIAN B. DODDS,
JOSEPH McCARTHY,
SAMUEL EDELSTEIN,
E. B. QUACKENBUSH,
Spokane, Washington,
Solicitors for Appellants and Petitioners.

The principal points raised by the trustee in his brief may be conveniently grouped under four heads. It is first contended that the claimants have no superior equities in the fund in controversy over the other customers of the bankrupt. It is next urged that there is no distinction to be drawn between the equities of cash and margin dealers. The third contention is that if any customer of Whitehouse who was entitled to securities pledged with Hutton failed to claim his property, his rights therein vested in the trustee, who may now assert them as against these petitioners. Lastly it is argued that the claimants, save Lane and Theis, have failed to trace the proceeds of their securities into the fund in question because, as appears from the list on pp. 3, 4, 5 and 6 of the trustee's brief, the securities of all other claimants were sold prior to a time when the proceeds of all sales equalled the debt due Hutton.

We disregard the argument that there can be no claim on the unjust enrichment theory since we have never advanced it, believing it to have no bearing on the present controversy. We are likewise disregarding the fifth subdivision of the trustee's Brief of Argument which turns on the case of In re *Toole,* 274 Fed., 337, since we do not desire to add to our discussion of this case in our opening brief.

We will take up these contentions of the trustee in the same order that we have set them out, first turning our attention to the question of whether the equities of these claimants are higher than those of

the other customers of Whitehouse whose securities were included in the Hutton pledge, since it is our opinion that the determination of this question solves all problems arising in this controversy.

I.

These petitioners are possessed of equities higher than those of the other customers of Whitehouse whose securities were included in the Hutton pledge.

It is our contention that those who authorized Whitehouse to pledge their securities with Hutton have not the same equities as have those whose securities were pledged by him without their authority, since the first group voluntarily submitted their property to the perils through which it was lost to them. It is further our belief that the bankrupt had the right to pledge the securities of marginal customers but did not have such right over the securities of those who had paid in full.

An examination of pp. 74 to 87 of the Transcript, on which are set out the matters of importance in the individual claims, will disclose that all these petitioners, with the single exception of Wittmer, had paid in full for their securities before the failure on August 3, 1921. The majority had made voluntary payments in currency, and the balance had paid in full by Whitehouse's conversion of their securities. As a result, in no instance did he have the right on that date to hold their properties in pledge. In our opening brief we have already called to

the attention of the court the various cases which hold that after a customer has paid the full amount of his indebtedness the broker has no further right to retain his property in pledge, and it is unnecessary to refer to them again here, especially since the stipulation likewise covers this particular point. It is agreed on pp. 64 and 65 of the Transcript that "In all marginal dealings it was agreed between Irving Whitehouse Co. and the customer that the securities purchased as well as the collateral put up by the customer to secure his account with the bankrupt might be rightfully pledged. * * * It was understood that if the amount due on any account was paid in full, the bankrupt must at once deliver either the identical securities put up as collateral, or purchased, or others exactly similar thereto."

One J. C. Bird, an accountant of the bankrupt, testified on behalf of Stephens to the same effect. See pp. 88 and 89 of the Transcript. "Our practice was to carry as a marginal transaction any stock on which there was some balance due, no matter how small, and we considered we had the right to hold stock purchased in pledge until the full purchase price was paid, and this was the way we carried this transaction and is the general custom of stock-brokers."

The same witness, later, at pp. 99 and 100 of the Transcript, in testifying for the benefit of O. W. Wittmer, said: "It is the custom in all marginal transactions carried on between the broker and his

customer that the broker may rehypothecate any securities which he holds on the customer's account so long as this customer remains indebted to him."

It must follow from the foregoing that since none of these petitioners were indebted to Whitehouse he had no authority to pledge any of their securities. That being true, if all the other customers were possessed of equities equal to theirs it must be because they were not marginal traders but had likewise paid in full. The stipulation, however, shows a contrary state of facts to exist. It is said on p. 64 of the Transcript: "As a matter of fact almost all the collateral held by Hutton & Co. to secure the Irving Whitehouse Co. account was composed either of the securities bought by marginal traders or deposited by them as collateral." Again it is agreed on p. 72, after reference is made to the securities owned by Whitehouse, that, "the rest belonged to customers of Irving Whitehouse Co., by far the greater amount being property of marginal dealers."

These quotations would seem to settle that Whitehouse had authority to pledge the securities of marginal customers and that the majority of those persons whose securities were included in the Hutton pledge were marginal customers. If then it be true that these petitioners had paid in full for their securities and that their doing so had deprived Whitehouse of the right to pledge, it must follow that their equities are greater than those of the other customers.

It is not necessary and, of course, it is impossible for us to demonstrate conclusively that we are the only persons possessing such superior right, or, as is sometimes said, are the only "Class A" claimants. To establish this it would be necessary to investigate the account of each of the Whitehouse customers, together with all correspondence carried on between every customer and the broker. Apparently the expense of such an undertaking would be prohibitive. However, although we do not feel that it is incumbent upon us to make this attempt, we are, nevertheless, able to prove that in all probability we are the only persons entitled to be grouped in "Class A". It appears from the record that the failure took place over two years ago. The first petition filed by any of these claimants was recorded in February of 1922 so that these proceedings have been pending for over a year and a half. In September of 1922 the few petitioners who had then appeared obtained an order from the referee awarding them the value of their securities, and shortly thereafter the remainder of these claimants came before the court demanding their property. The court will take notice of the fact that all litigation arising from such a failure as this receives a large amount of publicity. It is also true that the great majority of creditors after receiving news of this award consulted attorneys to ascertain whether they might not recover on the same theory, and this assumption is borne out by the fact that about half of these petitioners came in directly after the date of that order.

Bearing in mind these facts and the further element that these proceedings have been of record for more than a year and a half in the bankruptcy files, where any creditor who investigated must have seen them, is it unreasonable to suppose that all, or at least nearly all, of the customers had actual knowledge of these proceedings and that a great majority made some investigation to determine whether they were entitled to be included in the favored "Class A"? This supposition, which, it must be confessed, is entirely reasonable, can be overthrown only by some presumption of fact established by well known rules of evidence. The only presumption, however, which seems applicable to the situation lends its aid to the support of our contention. It will always be presumed that an individual in his dealings with others has violated no duty which he owes them and this presumption of innocence will be indulged in until the contrary is shown. In order that there might be other "Class A" claimants it would be necessary to show either that Whitehouse had pledged securities other than those of these petitioners which had been paid for in full or that he had converted securities of his other customers in such quantities as to wipe out their debit balances.

Although the presumption of innocence may be weakened by showing other violations of trust, it is not overcome thereby, and the court will not act upon the theory that because Whitehouse misappropriated the property of one customer he misappro-

priated the property of all, but will rather consider that each breach of trust was the result of a pressing necessity for funds at some particular time and not that the bankrupt had made a practice of converting the securities of every person who trusted him. This presumption so applied will, moreover, work out justice here. If the trustee believes that in certain cases he is entitled to superior equities because persons who might have been grouped in "Class A" voluntarily waived such right and elected to claim as general creditors, he should be under the necessity of proving the facts on which such claim is based, and certainly we should not be under the necessity of proving that every one of several hundred creditors was not a member of a particularly fortunate group.

We have dealt thus at length with this question of relative equities since we believe that its determination clears up the other contentions of the trustee, with the exception of his argument that there has been a failure to trace.

II.

Cash customers and marginal customers whose securities, in part, have been converted possess equities higher than those of marginal dealers whose securities were not converted.

The trustee, to bolster his theory that these petitioners are not possessed of higher equities than those of other customers of Whitehouse, asserts that

in determining the equities of claimants there is no difference between cash customers and marginal dealers, and quotes portions of the Goodwin and English claims in the case of In re *J. C. Wilson,* 252 Fed., 631.

The Goodwin claim seemed to us clearly in our favor and was quoted at considerable length in our opening brief as sustaining the theory that if securities of a customer had been converted and a restatement of the account showed a credit balance in his favor he was entitled to be grouped in "Class A" along with those who had at the outsit paid in full for their securities. In this respect it is true there is no distinction between cash customers and marginal customers whose securities have been converted, but the reason that there is no distinction is not that cash customers have been degraded to the general level of marginal dealers, but that certain marginal dealers through the conversion of their securities have been elevated to "Class A". A glance at the rules of classification according to equities laid down by the court at p. 650 and quoted in our brief at p. 19 shows this to be true.

The English claim is cited in our brief at p. 28 as explaining the doctrine of the Pierson case. In this claim it developed that the broker had in pledge at the time of the failure insufficient shares of a certain security, Ray Consolidated, to satisfy the demands of all long customers. Some of these customers had paid in full for the securities they had

ordered while others were marginal dealers. Under the doctrine of the *Pierson* case and *Duel v. Hollins,* it was held that each was entitled only to his respective proportion of the securities on hand irrespective of whether the others who were entitled to these securities claimed or not. The cash customers endeavored to increase their proportions by eliminating the claims of marginal customers, and to do this advanced the theory that it must be presumed that in converting the stock the broker sold first the securities of marginal customers. The court held that since the broker had no more right to *sell* the securities of marginal customers than he had to sell the securities of cash customers, the wrong done one group was as great as that done the other, and that consequently the presumption could not be indulged in. As was said in our opening brief, this case is an authority only on the question of identifying or tracing securities in the pledge and does not concern itself with the equities of those who have traced, since the determination of equities takes place only after the tracing is completed, as appears from our quotation from the case on p. 28 of our brief.

III.

If it be assumed that the trustee receives the rights of those customers whose securities were pledged with Hutton, but who did not claim restitution, this will not avail him, unless he has proved that such non-claiming customers had rights equal to these petitioners.

Much space in the trustee's brief is devoted to developing the theory that if any customer, whose securities were pledged with Hutton, failed to claim them or their proceeds, his rights descended to the trustee, who might, thereafter, assert them as against other customers who did claim redemption. He relies exclusively on the case of In re *Archer Harvey & Co.,* 289 Fed., 269. Without discussing whether or not this case lays down the correct doctrine, it is worthy to note that it deals exclusively with what we have termed "Class B" claimants, that is persons who had consented to a pledging of their securities, it being said on p. 269 that "In the case now at this bar, most, if not all, the petitioners owed the bankrupts greater or less sums and the securities in which they are now trying to assert rights were delivered to the bankrupts or left with them to protect their indebtedness."

Our answer to this contention of the trustee is the same that we have set up to meet his other arguments—these petitioners possess higher equities than the other customers of Whitehouse. While it might

well be urged, where only the demands of "Class B" claimants are involved, that the trustee is vested with the rights of those who do not seek restitution and may assert these rights as against customers who do but whose equities are no higher than the others, yet it must be apparent that this same contention cannot be successfully raised as against petitioners who stand possessed of higher equities than the customers through whom the trustee claims. Apparently the interest of the trustee cannot be greater than the interest of the customers who, it is said, have conferred their rights upon him by their election to come in as general creditors and if, therefore, such creditors could not successfully have contested the right of these petitioners to recover, they cannot confer upon the trustee rights or equities that will enable him to contest our claims, or if, as a matter of fact, certain of these non-claiming creditors were possessed of equities equal to ours, the trustee must prove that fact, if he seeks to recover on it, for the reasons suggested earlier in this brief.

IV.

The fact that the securities of certain petitioners were sold at a moment when the sum total of all preceding sales did not equal the amount due Hutton does not bar such petitioners from the right of asserting their interests in this fund.

The trustee has arranged a list of the pledged securities showing the times of the various sales. It is agreed that all securities were sold out together under a blanket order of the receiver, and the short interval that elapsed between each sale shows that the sale was, as a matter of fact, but one transaction. It, nevertheless, appears to be the trustee's contention that because the securities of certain petitioners were sold at a time when the proceeds derived from all prior sales did not equal the debt, that such securities did not survive and therefore may not be traced into the fund.

A case squarely in point is the claim of Rolph in In re *J. C. Wilson,* 252 Fed., 631. That case differed from the one now at bar in that the fund was insufficient to satisfy all "Class A" claimants. Rolph, as to certain of his securities, was entitled to be placed in that group, but asserted higher rights due to the fact that his securities had not been sold. It would be impossible to improve on the reasoning of the court. See p. 639, where it was said:

> "If, however, it be held that, after a petition in bankruptcy has been filed, the pledgee, by

> selecting for sale some stocks and not others, can thereby save some stocks intact for the owners without the burden of contribution, and not others, it can readily be seen that the door will be opened for the most indefensible kind of favoritism, and possibly for corrupt bargains between the owners of securities and the pledgee. Indeed, a pledgee of his own motion, without any agreement with owners of securities,could easily safeguard his friends to the detriment of others who were strangers to him. I am fully satisfied, therefore, that Rolph is in the same position as other class A claimants."

See also:

In re *Toole,* 274 Fed., 337.
In re *Mills,* 110 N. Y. S., 314.

In concluding we desire once more to put our theory of the case before the court. We contend that our equities are higher than those of the other customers of Whitehouse, and if the court finds against us on this phase of the case we are content to abide by the order of the District Court. But if they do find, as it seems to us they must, that our equities are superior to those of other customers, then it must follow that if such other customers were before the court we could satisfy our demands from this surplus fund before they might partake thereof, and if this would be true, it must likewise be true that the rights which the trustee claims to derive from them cannot be increased by the simple process of derivation, but must remain the same when vested in him as when vested in them and that consequently he can no more insist on an equal di-

vision with us than could his predecessors in interest.

Respectfully submitted,

GRAVES, KIZER & GRAVES,
WAKEFIELD & WITHERSPOON,
ALLEN, WINSTON & ALLEN,
FABIAN B. DODDS,
JOSEPH M'CARTHY,
SAMUEL EDELSTEIN,
E. B. QUACKENBUSH,
Spokane, Washington.
Solicitors for Appellants and Petitioners.